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Pay Ratio is a Go!: The Commission and the Division of Corporation Finance Provide Guidance and Updated C&DIs

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On September 21, 2017, both the Securities and Exchange Commission (the "Commission") and its Division of Corporation Finance ("Corp Fin") provided guidance on the pay ratio disclosure requirement mandated by the Dodd-Frank Act, thereby confirming recent indications from Bill Hinman, Director of Corp Fin, that the Commission had no intent to delay implementation of the pay ratio disclosure. Pay ratio disclosure is a go for the 2018 proxy season.

Commission Guidance

The Commission guidance, which can be found here, addresses three areas:

1. **Use of Reasonable Estimates, Assumptions, and Methodologies and Statistical Sampling**
   The pay ratio rule affords significant flexibility to registrants in determining appropriate methodologies to identify the median employee and calculating the median employee's annual total compensation. The disclosure may be based on a registrant's reasonable belief; reasonable estimates, assumptions, and methodologies; and reasonable efforts to comply with the disclosure requirements.

   In light of the permitted use of estimates, assumptions, adjustments, and statistical sampling, the Commission noted that the pay ratio disclosure may involve a degree of imprecision, which has prompted some concerns about compliance uncertainty and potential liability. To ease these concerns, the Commission stated that "if a registrant uses reasonable estimates, assumptions or methodologies, the pay ratio and related disclosure that results from such use would not provide the basis for Commission enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith."

2. **Use of Internal Records**
   The Commission provides guidance as to the use of existing internal records, such as tax or payroll records, to determine the median of the annual total compensation of all its employees[1].

   (a) *Non-US Employees*
   To address concerns regarding compliance costs, the pay ratio rule permits registrants to exempt non-U.S. employees where these employees account for 5% or less of the registrant's total U.S. and non-U.S. employee population, with certain limitations. In the guidance, the Commission clarifies that a registrant may use appropriate existing internal records, such as tax or payroll records, in determining whether the 5% de minimis exemption is available.

   (b) *Median Employee*
   In the guidance, the Commission clarifies that a registrant may use internal records that reasonably reflect annual compensation to identify its median employee, even if those records do not include every element of compensation, such as equity awards widely distributed to employees.

1 Item 402(u) of Regulation S-K requires a registrant to disclose the median of the annual total compensation of all its employees excluding its principal executive officer.

The Commission also recognized that, when calculating total compensation for the median employee identified by the registrant using a consistently applied compensation measure based on internal records, a registrant may determine that there are "anomalous characteristics" of the median employee's compensation that have a significant impact, either higher or lower, on the pay ratio. In the guidance, the Commission noted that the registrant does not need to conclude its methodology was unsuitable to identify its median employee in such cases. Instead, the registrant may substitute another employee with substantially similar compensation to the originally identified median employee based on the compensation measure it used to select the median employee.

3. Independent Contractors
   In determining who is an "employee" for purposes of the pay ratio rule, the Commission clarified that the registrants may apply a widely recognized test under another area of law, such as employment law or tax law, that the registrant otherwise uses to determine whether its workers are employees. For example, such a test might be drawn from guidance published by the Internal Revenue Service with respect to independent contractors.

Division of Corp Fin Guidance

Corp Fin's guidance, which can be found here, assists registrants in determining how to use statistical sampling methodologies and other reasonable methodologies to determine its median employee.

Specifically, Corp Fin's guidance:

- notes that registrants are permitted to use statistical sampling, other reasonable methods or a combination of statistical sampling and other reasonable methods. For example, a registrant with multinational operations or multiple business lines is permitted to use sampling for some geographic/business units and a combination of other methodologies and reasonable estimates for other geographic/business units;
- provides examples of sampling methods that could be appropriate to use (alone or in combination) depending on the registrant's particular facts and circumstances, such as simple random sampling, stratified sampling, cluster sampling and systematic sampling;
- provides examples of situations where registrants may use reasonable estimates, such as identifying the median employee, evaluating the likelihood of significant changes in employee compensation from year to year and using the mid-point of a compensation range to estimate compensation;
- notes that registrants may use other reasonable methodologies (or a combination of methods) to determine the employees from which the median employee is identified and provides some examples of common statistical techniques registrants may consider, such as reasonable methods of addressing extreme observations, such as outliers; and
- provides hypothetical examples of the use of reasonable estimates, statistical sampling and other reasonable methods to identify the median employee. The hypotheticals involve three companies with more complex international operations and work forces.

Updated C&DIs

The three changes to the relevant C&DIs, which can be found here, are as follows:

1. New C&DI 128C.06 indicates that the staff will not object if a registrant refers to the pay ratio as an "estimate" in its proxy statement.
2. C&DI 128C.01 was revised to add a reference to the Commission's guidance confirming that any measure which reasonably reflects the annual compensation of employees, based on the facts and circumstances of a registrant, could serve as a consistently applied compensation measure, and that a registrant may use its internal records to identify the registrant's median employee, even if those records do not include every element of compensation.
3. C&DI 128C.05 was withdrawn. It had provided that a registrant should include a worker as an "employee" for the purposes of Item 402(u) if the worker's compensation is determined by the

registrant or one of its consolidated subsidiaries. According to the withdrawn C&DI, this was true regardless of whether such worker would be considered an "employee" for tax or employment law purposes, which would have conflicted with the Commission's latest guidance regarding independent contractors described above.

Primary Takeaways from the Guidance

Both the Commission and Corp Fin make it clear that there is no one-size-fits-all approach to pay ratio disclosure. Each registrant should carefully evaluate its own facts and circumstances, including, but not limited to, the size and geographic locations of its workforce and the variety and quality of its internal records, in determining how to comply with the pay ratio disclosure requirements. Assuming a registrant has a reasonable basis for the use of its various estimates, sampling techniques and other methodologies, and has provided its pay ratio disclosure in good faith, the registrant should have no concern about potential liability due to the inherent imprecision in the pay ratio disclosure.

For more information on the matters discussed in this Locke Lord QuickStudy, please contact the authors.

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